Readings Week 4: Porter's Five Forces

General Ideas/Main Points:

· Competition for profits goes beyond established industry rivals to also include four other competitive forces: customers, suppliers, potential entrants, and substitute products.

· Although many different factors can affect industry profitability in the short run, it is the industry structure which drives competition and profitability in the medium and long run. Industry structure consisting of the five forces:

1. Threat of new entrants
2. Bargaining power of suppliers
3. Threat of substitute product or service
4. Bargaining power of buyers
5. Rivalry among existing competitors

· The configuration of the five forces will differ within each industry, and the strongest competitive force, or forces, should determine the profitability of an industry. These will become the most important to strategy formulation. provides a framework for anticipating and influencing competition.

· **The relative configuration of the five forces within an industry will basically determine how the economic value of the industry is divided; such as how much is retained by companies in the industry (profit), and how much is bargained away by customers and suppliers, limited by substitutes, or constrained by potential new entrants.**

· The forces reveal the most significant aspects of the competitive environment. They also provide a baseline for sizing up a company's strengths and weaknesses: Where does the company stand versus buyers, suppliers, entrants, rivals, and substitutes? Thus providing a guide for strategic action such as finding a position in the industry where the forces are weakest.

Notes/Summary:

- **Threat of new entrants:**

  · Can put pressure on price and costs, therefore putting on cap on potential profit in the industry.

  · Existing incumbents can act in several ways to deter new entrants, increasing barriers to entry. Existing firms can have advantages independent of their size: incumbents may have cost or quality advantages not available to potential rivals. entry barriers are advantages that incumbents have relative to new entrants.

  · Expected retaliation is a large factor in deterring the threat of new entrants, Incumbents often use public statements and responses to one entrant to send a message to other prospective entrants about their commitment to defending market share

  · E.G The expiration of a patent may unleash new entrants

  Barriers to entry:

a. supply side economies of scale: produce larger volumes with lower costs

b. demand side benefits of scale: buyers willingness to pay for product increases with number of buyers who patronize the company. discourages new entrants (customer base)

c. customer switching costs: Fixed costs buyers pay to change suppliers. larger the switching costs harder for new entrants to gain customers
d. capital requirements
e. incumbency advantages independent of size: incumbents may have cost or quality advantages not available to potential rivals.
f. unequal access to distribution channels: ex. cheap airlines, don't use travel agents as they prefer high fares.
g. restrictive govt. policies: regulated inustries, govt. can prevent people entering

- **The Power of Suppliers:**

· Powerful suppliers can capture more value for themselves by charging higher prices, limiting quality or services, or shifting costs to industry participants. E.G Microsoft Operating Systems.

- **The Power of Buyers:**

· Powerful customers can capture value by forcing down prices, demanding better quality or more service (thereby driving up costs)
· Large-volume buyers are particularly powerful in industries with high fixed costs
· Intermediate customers gain significant bargaining power when they can influence the purchasing decisions of customers downstream. Consumer electronics retailers, jewellery retailers, and agricultural-equipment distributors are examples of distribution channels that exert a strong influence on end customers.

- **The Threat of Substitutes:**

- A substitute performs the same or a similar function as an industry's product but by a different means –Note: usually of relative value.
- When the threat of substitutes is high, industry profitability can suffer. Substitute products or services will limit an industry's profit potential by placing a ceiling on prices. If an industry does not distance itself from substitutes through product performance, marketing, or other means, it will suffer in terms of profitability - and often growth potential.
- sometimes overlooked as they may appear very different to the product.

- **Rivalry among existing competitors:**

- Competition among existing competitors may take several forms such as price discounting, new product introductions, advertising campaigns, and service improvements. High rivalry will limit the profitability of an industry.

- Price competition is most liable to occur if: Products or services of rivals are nearly identical and there are few switching costs for buyers. This encourages competitors to cut prices to win new customers. Years of airline price wars reflect these circumstances in that industry.

Other Important Considerations:

- **Industry growth rate.** A common mistake is to assume that fast-growing industries are always attractive
- **Technology and innovation.** Advanced technology or innovations alone are not enough to make an industry structurally attractive; low-technology industries with price-insensitive buyers, high switching costs, or high entry barriers arising from scale economies are often far more profitable
- **Government** is not best understood as a sixth force. The best way to understand the influence of government on competition is to analyse how specific government policies affect the five competitive forces.
- **Complements** are important when they affect the overall demand for an industries product. - affects profitability like the five forces. positive or negative influences can affect the threat of substitutes.

Changes in industry structure:
shifting threat of new entry: making it hard for new companies
changing supplier or buyer power:
shifting threat of substitutes: advances in technology create new substitutes or shift price performance comparisons in one direction or the other.

Implications for strategy:
need to look at five forces first. it tells us why we are profitable. forces reveal most significant aspects of environment.

- Positioning: find a portion of industry where forces are weaker
- changes in the industry: new and promising competitive positions may appear. new ways to serve existing needs.
- Shaping industry structure: firm can lead industry to new ways of competing.
- competition and value.
- Redividing profitability: to capture more profits for industry rivals, the starting point is to determine which force or forces are currently constraining industry profitability and address them.
- The strategists goal is to reduce the share of profits that leak to suppliers, buyers and substitutes or are sacrificed to deter entrants